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60 YEARS OF SERVICE

February 17, 2005

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative entitled "The California Deficit Prevention Act" (File No. SA2005RF0014). This measure makes changes to the California Constitution related to state and local appropriations limits, K-14 education funding, the budget process, voting requirements relating to tax measures, state debt, fees, and local mandates.

MAJOR PROVISIONS OF THE MEASURE

Provisions Related to Appropriations Limits

Current Law

Article XIII B of the Constitution places annual limits on the appropriations of tax proceeds that can be made by the state, school districts, and local governments in California.

Calculation of the Spending Limit. The annual spending limit for each jurisdiction is based on the amount of appropriations in 1978-79 (the base year), as adjusted each year for population growth and cost-of-living factors. For the state, "population" is equal to a weighted average of statewide population and K-14 school average daily attendance (ADA), and "inflation" is equal to the growth in California per capita personal income.

Appropriations Subject to the Limit. In general, appropriations subject to the limit are equal to all appropriations funded from the proceeds of taxes (both General Fund and special fund), except for those which are specifically exempted

under Article XIII B. Exempt appropriations include debt service, qualified capital outlay spending, local mandate subventions, retirement and unemployment insurance payments, transportation expenditures supported by a portion of the state excise tax on gasoline, and subventions to other levels of governments (the latter being counted against the recipient entities' spending limits).

Disposition of Excess Revenues. At the state level, revenues are defined as "excess" if they exceed the appropriations limit over a two-year period. Such revenues are then divided equally between taxpayer rebates and onetime appropriations to K-14 schools.

Current Room Under State's Limit. Based on estimates in the Governor's 2005-06 proposed budget, the state is $9.4 billion below its appropriations limit in 2004-05 and will be $9.7 billion below the limit in 2005-06. This large gap opened up in 2001-02 following the steep revenue downturn in that year.

Reserve Provisions. The current limit requires that the state maintain a prudent reserve. Proposition 58 (approved by voters in March 2004) established a specific General Fund reserve entitled the Budget Stabilization Account (BSA), and requires that annual amounts of General Fund revenues be transferred to the account beginning in 2006-07. Each year, 50 percent of revenues allocated to the fund will be used to repay any outstanding deficit-financing bonds. The remainder is available to the General Fund upon a majority vote of the Legislature.

Legislative Spending. Annual growth in the Legislature's budget is limited to the change in the state's appropriations limit.

Proposal

Beginning in 2006-07, this measure eliminates the existing constitutional provisions relating to state and local appropriations limits and replaces them with a new, more comprehensive limit on state government spending. Local jurisdictions would no longer be subject to an appropriations limit. However, the measure prohibits a local government from spending in any year more than it receives in revenues (including reserve funds).

Some of the main provisions related to the coverage, level, and annual growth rates for the proposed limit are as follows:

- The new state limit would generally apply to *all* state General Fund and special funds *spending* (versus appropriations). Annual transfers to the BSA would not count against the limit (although spending *from* the BSA account would).

- The spending limit in the initial 2006-07 year would be equal to the actual amount of spending in 2004-05 as adjusted for the two-year increase in California population and the cost of living. The increase in cost of living is based on a weighted index consisting of (1) the U.S. consumer price index for health care (weighted according to the share of state expenditures devoted to health programs) and (2) the *lesser* of (a) per capita personal income or (b) the California consumer price index (weighted according to share of state expenditures devoted to non-health-care programs).
- The spending limit in subsequent years would be based on actual spending in the prior year as adjusted for changes in population and the cost of living (as defined).

Disposition of Excess Revenues. In contrast to the current limit, where excess revenues are established over a two-year period, this measure requires excess revenues to be established annually. Any such excess would first be proportionally allocated between the General Fund and each special fund. The portion attributed to special funds would be held in reserve for expenditures in a subsequent year. The General Fund's share would be allocated in the following manner:

- Twenty-five percent would be deposited into a newly created Special Reserve Account, until the account's balance reaches 5 percent of allowable expenditures for the year. Money from the reserve account could be used for either an emergency (as defined in the measure), or to support spending in years that revenues fall below the expenditure limit.
- Up to 50 percent would be allocated through the annual budget acts for one or more of the following purposes: (1) repay maintenance factor outstanding as of June 30, 2005 (discussed below under Proposition 98) at a rate of no more than one-fifteenth of the amount per year; (2) repay loans made from the Transportation Investment Fund in 2003-04 and 2004-05, with annual amounts not to exceed one-fifteenth of the balances as of June 30, 2005; and (3) repay outstanding deficit-financing bonds.
- Twenty-five percent could be used for local school or highway construction projects.

Any remaining funds would go to the Sales Tax Rebate Account. Moneys in this account would accumulate until there were sufficient amounts to allow for the reduction of the state sales tax rate by at least one-quarter cent for a 12-month period.

Other Provisions and Definitions. The measure would allow spending in excess of the limit for an emergency. It defines "emergency" for this purpose to be a

natural disaster or a condition of extreme peril to public safety. It states that an emergency does not include fiscal peril caused by revenue shortfalls, excessive spending, or imprudent budgetary decisions. The measure also:

- Provides that the limit could be increased for a four-year period upon approval by a two-thirds vote of each house of the Legislature and a majority of the voters in the following statewide election.
- Ties annual growth in the Legislature's budget to the revised spending limit growth factor.
- Makes a minor change to current constitutional provisions related to employee rights mandates.

Provisions Related to Proposition 98 Funding

Current Law

Proposition 98 Minimum Funding Guarantee. Proposition 98 establishes an annual funding mechanism for K-14 education. As modified in 1990, the actual amount of Proposition 98 spending in the prior year is adjusted for changes in ADA and per capita personal income. This adjustment is often referred to as the "Test 2" growth factor. This Test 2 factor is similar to that used for the state's appropriations limit. Thus, over time, the long-term school funding guarantee grows at a rate which is roughly similar to the appropriations limit.

Test 3 and Maintenance Factor. K-14 funding can be reduced below the level required by Test 2 when either (1) the guarantee is suspended through a two-thirds vote of the Legislature or (2) an alternative funding formula becomes operative during low-revenue years ("Test 3"). In either case, a "maintenance factor" is established, which is equal to the difference between actual appropriations and the higher level required by Test 2. In subsequent years, the maintenance factor can be "paid off" (thereby causing spending to rise up toward the Test 2 level) through a formula that allocates extra funding to education in above-average revenue growth years. The maintenance factor can also be paid off through additional appropriations by the Legislature. Because of the operation of Test 3 in 2001-02 and the suspension of the guarantee in 2004-05, the state currently has approximately $4 billion in maintenance factor outstanding. The speed with which this maintenance factor will be paid off depends on (1) the future performance of revenues and the economy and (2) policy decisions relating to future appropriations.

Proposal

This measure:

- Replaces the Test 2 cost-of-living factor (annual percent change in per capita personal income) to the revised cost-of-living factor used for the state's proposed spending limit.
- Eliminates the operation of Test 3 and accumulation of future maintenance factors.

The maintenance factor that is outstanding at the conclusion of 2004-05 could be paid off, under the measure's provisions, with revenues in excess of future spending limits, at a rate of no more than one-fifteenth of the amount outstanding annually.

Provisions Related to Budget Process

Current Law

Background. The Constitution vests the power to appropriate funds with the Legislature. The annual state budget is the Legislature's primary method of authorizing expenses for a particular year. The Constitution requires that (1) the Governor propose a budget on January 10 for the next fiscal year (beginning the following July 1), and (2) the Legislature pass a budget by June 15.

When the Governor receives a budget bill, he or she may then either sign or veto it. The Governor may also reduce certain individual appropriations in the budget before signing the measure. However, this line-item veto authority cannot be applied to some programs where expenditures are governed by separate laws. Also, once the budget is signed, the Governor may not unilaterally reduce any appropriations.

Balanced Budget Requirements. As amended by Proposition 58 (approved by the voters in March 2004), the budgets passed by the Legislature, and ultimately signed into law, must be balanced, meaning that revenues must exceed expenditures.

Late Budgets. When a fiscal year begins without a state budget, most expenses do not have authorization for payment. Over time, however, a number of court decisions and legal interpretations of the Constitution have expanded the types of payments that may continue to be made when a state budget has not been passed. Consequently, when there is not a state budget, payments now continue for some portion of state employees' pay, debt service, and various programs authorized by the Constitution, federal law, or initiatives.

Midyear Adjustments. If an enacted budget falls out of balance, the Governor may declare a fiscal emergency and call the Legislature into special session to consider proposals to deal with the fiscal imbalance. If the Legislature fails to pass and send to the Governor legislation to address the budget problem within 45 days after being

called into special session, it is prohibited from acting on other bills or adjourning in joint recess.

Proposal

This measure makes changes to the budget process relating to late budgets and midyear adjustments.

Late Budgets. If the Legislature fails to pass a budget before a new fiscal year commences, this measure states that the appropriation levels in the prior-year's budget will remain in effect until a new budget is passed. If the continuing budget is not balanced, then the Governor is authorized to reduce appropriations proportionally to bring the budget back into balance. The reductions would apply to all appropriations except those for debt service, those required by federal law or regulations, or those required by contracts to which the state is a party.

Midyear Adjustments. Following the enactment of a budget, this measure permits the Governor to declare a fiscal emergency when either (1) the budget is falling out of balance (same as current law) or (2) expenditures are exceeding the spending limit (as revised by this measure). As in current law, the Legislature would have 45 days to pass legislation to address the fiscal emergency, and if it failed to do so it would be prohibited from considering other legislation or adjourning in joint recess. In addition, however, this measure would:

- Allow the Governor to reduce all items of appropriation proportionally, except for those which support debt service, are required by federal law or regulations, or are required by contracts to which the state is a party.
- Prohibit the Governor or legislative Members from receiving pay, per diem, or expense allowances until midyear legislation is enacted. No forfeited salary, per diem, or expense allowance could be paid retroactively.

Voting Requirements for State Tax-Related Legislation

Current Law. Legislation resulting in a *tax increase* must be approved by a two-thirds vote of both houses of the Legislature. Other tax-related legislation can be enacted with a simple majority vote of both houses. The determination of whether a measure constitutes a tax increase—and thus requires a two-thirds vote—is currently based on the *net* fiscal impact of its provisions. For example, a measure that results in higher taxes from some taxpayers but an equal (or larger) reduction in taxes from other taxpayers would not result in an aggregate increase in taxes, and thus can be passed with majority vote.

Proposal. This measure requires that a tax measure be subject to the two-thirds vote requirement if it results in a tax increase for *any* individual taxpayer—regardless of whether it raises or lowers aggregate taxes.

Definition of Taxes

Current Law. In addition to taxes, the Legislature and local governments may impose fees, assessments, and other charges on individuals and businesses. While the constitutional requirements regarding imposition of these levies vary, the requirements generally involve lower approval thresholds by the governing body and/or voters than is the case for taxes. Current law generally defines fees to be charges related to specific services or regulatory activities. Past court decisions, however, have allowed levies imposed on businesses for remediation or mitigation of past damages to be classified as fees. As a result, these levies are subject to approval by (1) a majority vote of the Legislature (instead of a two-thirds vote that would be required for a state tax) or (2) the local governing board (instead of approval by the local governing board *and* local voters that would be required for a local tax).

Proposal. The measure expands the definition of what is considered a state or local tax. For example, fees imposed for certain remediation and mitigation purposes and fees for services previously financed by tax revenues would be classified as taxes under this measure. As a result, after January 1, 2005, these levies would be subject to (1) a two-thirds vote requirement of the Legislature in the case of a state levy or (2) a vote of the governing body and local electorate in the case of a local levy.

Debt-Related Provisions

Current Situation. California issues general obligation (GO) and lease-revenue (LR) bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, water projects, and office buildings. Annual General Fund debt service for these types of bonds is estimated to be about $3.6 billion in 2004-05, representing about 4.6 percent of projected General Fund revenues during the year. (These numbers exclude the effects of Proposition 57 deficit-financing bonds.) Although financial markets consider debt-service ratios among many other factors when considering the creditworthiness of a state, there are no specific limitations on the amount of state indebtedness imposed by the credit markets or by state law.

Proposal. This measure prohibits the State Treasurer from issuing GO and LR bonds whenever the Department of Finance's projected debt-service ratio for the current year or any of the four subsequent fiscal years exceeds 6 percent of estimated General Fund revenues. The debt-service ratio calculations would not take into account costs associated with deficit-financing bonds.

Other Provisions

This measure prohibits that state from making any changes to existing budgetary/legal accounting practices that are not in compliance with Generally Accepted Accounting Principles.

FISCAL IMPACT

This measure would have potentially major fiscal impacts on state and local governments, beginning in 2006-07.

Effects of Spending Limit

Near-Term Effect. Since 2001-02, the state has faced a large "structural" shortfall between revenues and expenditures. Recent budgets have covered this shortfall partly through spending deferrals, loans, and other onetime or limited-term solutions. As the savings from these limited-term solutions expire, spending under current law will increase faster than revenues in both 2005-06 and 2006-07, leading to a re-emergence of the structural shortfall in those years, absent corrective actions.

Given these circumstances, the impact of the proposed spending limit on the 2006-07 budget would depend in large part on how the state addresses the structural shortfall during the 2005-06 and 2006-07 budgets. This is because the proposed limit would be roughly similar to current-law revenues in 2006-07, but be substantially below current-law state expenditures during 2005-06 and 2006-07. Thus, if the budget imbalances are eliminated through ongoing expenditure reductions, then the proposed limit would be reasonably close to estimated state spending in 2006-07. However, if the shortfalls are not addressed in this manner, then the proposed limit could be substantially below projected current-law expenditures. Similarly, if revenue growth proves to be stronger than currently expected, this measure would preclude the state from using the added revenues to address the budget shortfall.

Longer-Term Effects. Over the longer term, the proposed limit would grow somewhat more slowly than projected spending and revenues under existing law. As a result, this constraining feature of the new limit would have two impacts on the state:

- First, it would result in slower growth in state spending relative to current law.
- Second, it would trigger the excess revenue provisions of the measure.

The operation of the excess revenue provisions would result in a reallocation of spending away from most existing non-Proposition 98 programs and toward the

repayment of deficit bonds, outstanding Proposition 98 maintenance factor, outstanding transportation loans, and local school or road construction. After the build up of a reserve and the payoff of the above obligations, the measure could also lead to lower sales tax rates in the future.

Local Government Spending. The combination of a tighter state limit and the repeal of local limits could result in increased pressure on local spending over time. This could occur, for example, if the new spending limit caused the state to reduce support for local assistance programs in the areas of health, social services, criminal justice, or other programs.

Effects of Proposition 98 Provisions

There are four provisions in this measure that could affect Proposition 98 spending directly or indirectly.

- Changes to the Test 2 cost-of-living factor.
- The elimination of Test 3 and future accumulation of maintenance factor obligations.
- Inclusion of Proposition 98 spending in potential across-the-board spending reductions.
- Changes to the way the existing maintenance factor would be paid.

Changes to Test 2 Cost-of-Living Factor. Over the long-term, the Proposition 98 guarantee would grow more slowly under this measure because of the change in the cost-of-living factor from percapita personal income to a CPI based measure. As a general indication, over the past decade, the current-law Test 2 cost-of-living factor increased about 1.5 percent per year more than the proposed Test 2 cost-of-living factor.

Other Provisions. The net impact of the other provisions on Proposition 98 funding is uncertain. In low revenue years, for example, the elimination of the Test 3 calculations means that the minimum guarantee would be higher than under current law. On the other hand, the elimination of the maintenance factor provision would mean that the minimum guarantee would be "rebased" downward each time it was suspended by the Legislature. Similarly, the inclusion of Proposition 98 in across-the-board reductions by the Governor could also reduce the guarantee over time. The proposal's treatment of the existing outstanding maintenance factor would likely reduce K-14 funding relative to current law in the near term. The net impacts would depend on future "excess revenues," revenue growth, and policy decisions.

Effects of Budget Process Changes

The provisions allowing the Governor to make proportional reductions when budgets are delayed or fall out of balance would provide the executive branch more authority to unilaterally reduce spending. To the extent this authority were exercised, it would result in more immediate spending reductions when budgets fell out of balance. The impact of these reductions on individual programs would depend on various factors, such as which spending was excluded from the reductions because of federal requirements. For example, if a significant portion of spending on health and social services were excluded because of federal maintenance-of-effort requirements, the reductions in education, criminal justice, and other areas of the budget would be correspondingly greater. Also, it is unclear whether this measure would permanently reduce appropriations for certain state entitlement programs. This is because the language of the initiative does not explicitly adjust or suspend the underlying laws affecting the funding levels for the programs. Absent changes to these underlying laws, the reductions could need to be subsequently repaid.

Other Effects

The initiative would also have a variety of other fiscal impacts.

- ***Voting Requirements.*** By increasing voting requirements for certain tax-law changes, this measure could result in a different distribution of taxes and tax burdens in the future compared to what would occur under current voting requirements. However, it is not possible to determine the aggregate impact of these changes on state and local government revenues.
- ***Determination of Fees.*** The tightening of the definition of which levies are classified as fees would increase the voting requirements for certain types of levies. This could result in a reduction in certain fee revenues to the state and local governments.
- ***Debt-Related Provisions.*** The prohibition on borrowing in circumstances where the debt-service ratio exceeds 6 percent would not have an immediate effect on capital outlay borrowing, since the state's current debt-service ratio is below this threshold. However, the limitation could restrict borrowing at some point in the future, depending on borrowing needs, interest rates, and revenue levels. In such cases, there would be both reduced capital outlay spending and lower debt-service costs.

Summary of Fiscal Effects

The measure would have the following major fiscal impacts:

- Potentially significant reduction in the growth in state spending beginning in 2006-07, accompanied by potential reductions in taxes and fees over time.
- Slower growth in the minimum funding requirement for K-12 schools and community colleges. Unknown net impact on educational spending from other provisions affecting school finance.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance